12/5/80
B 5351-3

The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

NOVEMBER 1980

An Essay on Keynesian Economics

The lopsided election results may be open to several interpretations, insofar as economic policy is concerned. Clearly, the first is simply that the voters did not care for the policies pursued by the previous Administration and are hoping for something better from the incoming President and the new Congress. Beyond this statement, however, it becomes less certain what the voters had in mind. Did they reject Keynesian economics in favor of monetarism? Did they discard liberal economic policies in favor of conservative economics? Are they looking for someone who follows the concept of "rational expectations"? Or maybe is it "supply side" economics that the electorate yearns for as opposed to "demand management"?

For that matter, are they looking for *any* economic policy? More than once in recent months the media has severely criticized the economics profession, claiming it is anywhere from just "muddling through" to being in a "mood of exhaustion and inadequacy." In some ways the media cannot be blamed for criticizing economists since one eminent member of the profession was moved to remark some time ago that "the rules of economics are not working in quite the way they used to."

I don't profess to be able to read the voters' minds beyond the simple statement noted at the opening of this Report. That is—to paraphrase elections past, many people probably believed that it was "time for a change." For one thing, I don't believe that most people are aware that there are different economic philosophies, and that some have been tried and found wanting while others are waiting in the wings to show their efficacy. For another, I don't think that it should boil down to a question of rejecting one type of philosophy in favor of another because we haven't given *any* economic theory a chance to work.

In our collective efforts to make the present as comfortable as possible, we have neglected the future. Unfortunately, the future has finally arrived, and we are paying for our sins of the past. In other words—our economic problems (including the growing questioning of economists' abilities as well) do not stem from the rules of economics changing. Rather, we are in the mess that we are in because of our unwillingness to abide by the rules of economics that already exist.

What's Right With Keynes...

Since not a few people are interpreting the election as a "mandate" to get rid of Keynesian economics, I thought it would be appropriate to discuss this month just what has gone wrong with Keynesian economics—and what hasn't. Taking the latter first, the one part of Keynesian economics that, in my view, we should hold on to is the use of a balanced budget. Contrary to popular belief, Keynes never directly attacked the classical notion that the Federal government's budget must be in balance. What he said was that during periods in which the level of employment declines, the government "willingly or unwillingly" should run a budget deficit to provide unemployment relief. This deficit, quite naturally, would be financed by borrowing money—what Keynes called "loan expenditures." He believed that such actions would increase people's ability (and willingness) to consume, thus extricating the economy from recession.

Those who have written about Keynes in an effort to interpret his writings have drawn the conclusion that budget deficits are quite acceptable during periods of economic slack. I would agree. Some authors believe that Keynes had a cavalier attitude toward budget deficits, pointing to the views of many of his disciples who assert that deficits do not matter. With this I would disagree. If Keynes did not place great emphasis on the implications of a budget deficit beyond that of stimulating the economy, it is simply because he believed that deficits should not be used as a main tool of economic policy, and when they were, they were to be used during periods of economic slack. It is Keynes's followers, and the politicians whom they educated, that are to blame for the "cavalier" attitude toward budget deficits that subsequently developed in the 1950s and 1960s.

Copyright 1980
Manufacturers Hanover Trust Company
350 Park Avenue, New York, NY 10022

I recall one argument vividly: "Why worry about debt, when it is simply money that we owe to ourselves"? That was used as a justification by many so-called Keynesian economists to run persistent budget deficits even when the pace of economic activity was strong. This kind of thinking was brought to its apex when the notion of the "full employment balanced budget" was advanced. This view held that, while the economy might have been nominally expanding, it would never reach its full potential if the budget, calculated at hypothetical full employment, were in surplus. You can see where this led to a further departure from Keynes's basic notion of running deficits in bad times and surpluses in good times. Since "good times" were some phase of economic activity that could only be described theoretically, rather than a measure of what was actually happening, one could easily justify continued deficits in the budget.

To liberal economists, this seemed to assuage their concerns about high unemployment and unequal distribution of income. They could recommend policies that they earnestly believed would make the economy run even better than it might have been doing at the time. But it was the politicians to whom the notion of a "buy now, pay later" budget system proved most appealing, in that it provided an important assist in getting them elected. Politicians could now parade before the American people and promise all kinds of things without presenting a bill. There always seemed to be Federal money available to remedy whatever local ailment existed. And if it was not increased spending that they promised, it was lower taxes. Budget deficits soon became "acceptable" as a way of life. Little wonder that we got into the mess that we are in today!

The table to the right shows the sorry record of the postwar years as far as budget deficits and surpluses are concerned. As you can see, we have *not* followed Keynes's idea of running a deficit in bad times and a surplus in good times. Plainly, we have not had 12 recession years in a row, 20 out of the past 21 or 29 out of the past 37. Thus, before we are ready to cast off Keynesian economics altogether, we should observe that one aspect of his policies that might have worked—the idea of running budget deficits in bad times and surpluses in good times—was not allowed to because it was not adhered to.

What bothers me even more is that we have a new group of elected officials coming into Washington in January, committed to tossing out Keynesian economics in the name of fighting inflation—yet advocating what would amount to a substantial widening of the budget deficit. They want to cut taxes and increase defense spending before they can put into effect offsetting reductions in nondefense outlays.

FEDERAL BUDGET RECEIPTS AND OUTLAYS: FISCAL YEARS 1945-81

(Billions of dollars)

Fiscal year	Receipts	Outlays	Surplus or Deficit (–)
1945	45.2	92.7	–47.5
1946	39.3	55.2	–15.9
1947	38.4	34.5	3.9
1948	41.8	29.8	12.0
1949	39.4	38.8	.6
1950	39.5	42.6	–3.1
1951	51.6	45.5	6.1
1952	66.2	67.7	–1.5
1953	69.6	76.1	–6.5
1954	69.7	70.9	–1.2
1955	65.5	68.5	–3.0
1956	74.5	70.5	4.1
1957	80.0	76.7	3.2
1958	79.6	82.6	–2.9
1959	79.2	92.1	–12.9
1960	92.5	92.2	.3
1961	94.4	97.8	–3.4
1962	99.7	106.8	–7.1
1963	106.6	111.3	–4.8
1964	112.7	118.6	–5.9
1965	116.8	118.4	–1.6
1966	130.9	134.7	–3.8
1967	149.6	158.3	–8.7
1968	153.7	178.8	–25.2
1969	187.8	184.5	3.2
1970	193.7	196.6	–2.8
1971	188.4	211.4	–23.0
1972	208.6	232.0	–23.4
1973	232.2	247.1	–14.8
1974	264.9	269.6	–4.7
1975	281.0	326.2	–45.2
1976	300.0	366.4	–66.4
Transition Quarter	81.8	94.7	–13.0
1977	357.8	402.7	–45.0
1978	402.0	450.8	–48.8
1979	466.0	493.6	–27.7
1980 (preliminary)	520.0	579.0	–59.0
1981 (estimated)	605.0	632.4	–27.4

Sources: Department of the Treasury, Office of Management and Budget, House-Senate Conference Committee

This simply will not work. Its near-term impact on the Federal government's financing needs will be devastating, since any policy that calls for more spending and less taxes—regardless of what their classroom results might be—will in the real world widen an already swollen budget deficit. This will, in

turn, cause one or more of several possible adverse events to occur.

If the Federal Reserve continues to adhere to its present course of trying to slow the growth of the money supply to noninflationary proportions, then Washington's increased financing needs will have to be met by funds drawn from the private sector. This would imply not only less liquidity for business and consumers initially, but also higher interest rates as well. Higher interest rates, of course, make it less attractive—if not outright difficult—for business and consumers to spend.

Of course, the Federal Reserve could always "give in" and expand the supply of money and credit to meet Washington's increased financing requirements while accommodating everyone else. In this event, interest rates might stay stable for a while (and they might not, at that, since the financial markets are so sophisticated these days that they would catch immediately the extra injection of money into the system and begin to anticipate its inflationary consequences), but at the expense of worsened inflation later on. A higher rate of inflation drains purchasing power, thereby constricting consumer spending, while the higher interest rates that would eventually result will further depress economic activity by discouraging both consumer and business spending.

...What's Wrong...

Without question, there are aspects of Keynesian economics that are no longer applicable in today's world. Keynes did not believe in the automatic adjustment process that was central to classical or orthodox economic theory. At the heart of his General Theory was the proposition that a modern economy was unstable. He labeled as outstanding faults of the modern economy what he called the failure to provide full employment and an equitable distribution of wealth and income. The maintenance of high demand, therefore, became the central object of his economic policy. This entailed two things: managing the economy by government and managing by manipulating demand.

Looking at the world as it existed when Keynes matured and began studying and writing about economics, it is easy to see how he came to the conclusion of an inherently unstable economy. There were many booms and busts in the United States in its formative industrial years during the late nineteenth and early twentieth centuries. And if these cycles weren't enough, the Great Depression, during which his General Theory was written, probably provided sufficient evidence to Keynes that the economy needed some guidance from government.

However, we have learned a lot about economic theories and policies during the past half century. Those deficiencies in the system that produced booms and busts such as the absence of a central bank, reliance on a gold standard whose liquidity-creating abilities were not consonant with the economy's needs and, in general, a lack of understanding of when to run budget surpluses and when not to, have been largely remedied. The creation of the Federal Reserve, along with the end of the gold standard, and the development of such automatic stabilizers as unemployment insurance, Social Security and welfare sharply reduced the economy's tendency toward instability.

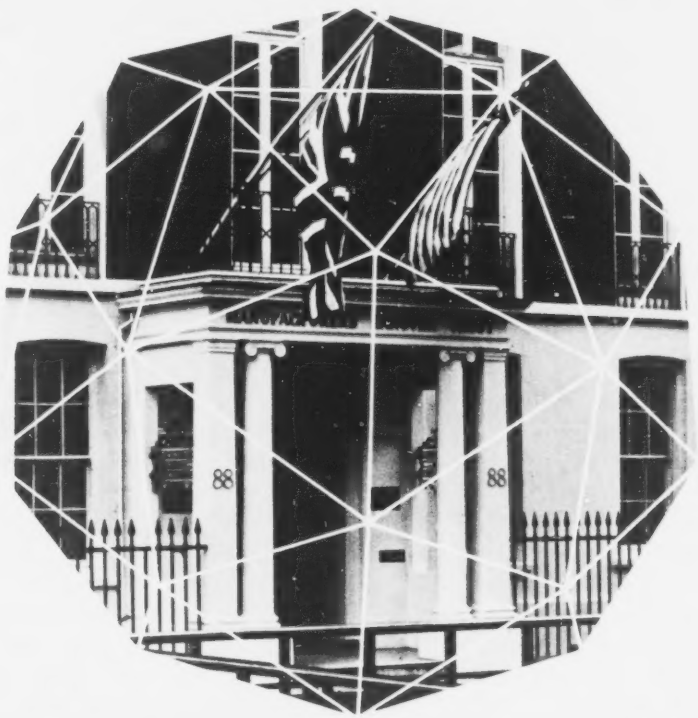
As it has been translated into specific policy, the one aspect of Keynesian economics that we have followed over the years, demand management, is one that should be put aside at this time. Demand management economics might have been appropriate for an era when the economy was performing well below par and needed the stimulus of government to expand consumption. That is to say, the Great Depression admittedly was a result of insufficient demand, thus it was right for the government to stimulate it. However, today's problem is not a lack of demand, but rather, insufficient supplies of goods—and more important, new productive machinery.

The Keynesian notion that supply increases will follow demand increases no longer holds true in a period of high inflation and high interest rates, both of which represent tremendous disincentives for business to invest. What is needed is a "new" economic policy that stresses supply instead of demand. Ironically, this "new" economics is not new but rather, is very old—as old as Adam Smith himself. This is because its focus is on economic growth through the encouragement of investment and production, and it sees such growth arising from a free response to the economic incentives of a free market. What is more, it believes that only the private sector can bring us sustained growth, thus there is a need to reduce the role of the public sector.

...And What Should Be Done

Therefore, before we pin the pro- or anti-Keynes labels on ourselves,—or, for that matter, before we discard Keynes altogether—we should remember that one aspect of Keynesian economics that has *not* been used (budget surpluses in good times; deficits in bad times) is still relevant, while another of his theories that *has* been followed (government interference in the economy through the vehicle of demand management) is no longer appropriate. In other words, the rules of economics still work—provided that we know what they are and follow them. ■

The Geobankers can put money to work for you in any convertible currency.



GEOBANKING®.

It is the way of worldwide banking at Manufacturers Hanover, a major U.S. bank with nearly $50 billion in assets and a tradition of service dating back more than a century.

GEOBANKING DEPOSIT FACILITIES.

Nearly $40 billion in local and international currency deposits are currently entrusted to the Geobankers on a global basis. By governments, banks, businesses and individuals.

These deposits take the form of current accounts to concentrate funds for business payments. Certificates of deposit that offer excellent marketability. Time deposits for longer-term investment. And a variety of other deposit accounts for earnings plus liquidity.

Put the total global commitment of Manufacturers Hanover to work for you. Contact a Geobanker today.

MANUFACTURERS HANOVER

The banking source. Worldwide.

Headquarters: 350 Park Avenue, New York, N.Y.

Member FDIC